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STATE FOR EAP/CM AND EEB/OMA, TREASURY FOR OASIA

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TAGS: ECON EFIN EINV ETRD HK CH
SUBJECT: HONG KONG RESIDENTS TOLD TO PREPARE FOR "PERSISTENT DIFFICULTIES"

¶1. Summary: Though they continue to assure the public that Hong Kong's financial foundation is sound, senior Hong Kong government (HKG) finance officials warned the global financial crisis would strike further blows to Hong Kong's economy. The latest government interest rate cut of 50 basis points (directly tied to the U.S. rate cut on October 30) has reportedly failed thus far to spur lending rate cuts by local banks; this will delay the rate cut's eventual economic benefits for Hong Kong businesses. Hong Kong's Consumer Council has identified 50 retail holders of Lehman Brothers-arranged "minibonds" it is prepared to support in a lawsuit should mediation efforts between minibond investors and the banks which sold the instruments fail. The Hang Seng Index fell 2.5 percent on October 31 but was up 9.4 percent for the week, reflecting the sharp mid-week rise in global equity markets. Overnight and one week HIBOR rates remained low at 0.6 and 1.0 percent, respectively, while longer-term rates remained roughly unchanged from the previous week. End summary.

Preparing for "Persistent Difficulties"

¶2. In remarks before the Legislative Council on October 30, Financial Secretary (FS) John Tsang said he is "not optimistic" about Hong Kong's economy next year. He described the current global financial crisis as "the worst since the Great Depression in the 1930s." He urged the public to prepare for "persistent difficulties." On a brighter note, FS Tsang restated the HKG's mantra that Hong Kong's financial system remains well capitalized, and that "the foundation of Hong Kong as a financial center is sound."

¶3. Although the Hong Kong Monetary Authority (HKMA) base rate declined 50 basis points to an all-time low of 1.5 percent -- in lock step with the rate cut in the United States -- Hong Kong banks have thus far not reduced their prime lending rates. Hang Seng Bank General Manager Andrew Fung said Hong Kong's banks are fearful of rising individual and systemic credit risks. HKMA Chief Executive Joseph Yam said tight lending policies at banks will delay the benefits to Hong Kong's economy from the rate cut. Yam reiterated that the HKMA stands ready to inject liquidity into the HIBOR market as needed.

¶4. Yam warned that Hong Kong's USD 180 billion (HKD 1.4 trillion) Exchange Fund -- the reserve that backs the Hong Kong dollar -- will post its third consecutive quarterly loss, and is likely to record an annual loss for the first time in the Fund's history. Bonds comprised 73.5 percent of the Fund as of June 30, 2008, with equities and other investments totaling 19.2 percent and 7.3 percent, respectively.

Contingency Planning for Minibond Litigation

¶5. Mediation efforts continue between disgruntled retail investors and the banks who sold "minibonds" arranged by Lehman Brothers. Hong Kong's Consumer Council (HKCC) announced on October 30 that it has identified 50 complainants it may support in joint legal proceedings against the banks if mediation efforts fail. (Note: The HKCC was created in 1974 and is a statutory body, independent of the Hong Kong government. The HKCC carries out its work through over 125 paid staff employed in a number of functional divisions, including the Complaints and Advice Division and the Trade Practices Division. The HKCC collects and disseminates information to consumers and government on matters affecting consumers in the marketplace, and receives and examines complaints from consumers. End note.) If a Hong Kong court were eventually to rule in favor of the joint complainants, the decision might set a precedent for handling the over 3,600 other complaints received by the HKCC.

Market Wrap Up

¶6. The Hang Seng Index (HSI) closed down 2.5 percent at 13,969 on October 31. Despite Friday's losses, mid-week gains drove the HSI 9.4 percent higher for the week. The short end of the HIBOR curve remained liquid, with the overnight and one week lending rates at 0.6 percent and 1.0 percent, respectively. Other HIBOR rates as of 1730 local

time: one month 2.3 percent; three months 3.35 percent; and six months 3.5 percent.
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